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**CONGRESSIONAL TESTIMONY**

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**“Legislative Proposals to Enhance Capital Formation  
and Reduce Regulatory Burdens: Venture Exchanges”**

**Testimony  
before the  
Capital Markets and Government Sponsored Enterprises Subcommittee  
of the  
Committee on Financial Services  
United States House of Representatives**

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My name is David R. Burton. I am Senior Fellow in Economic Policy at The Heritage Foundation. I would like to express my thanks to Chairman Garrett, Ranking Member Maloney, and members of the subcommittee for the opportunity to be here this morning. The views I express in this testimony are my own and should not be construed as representing any official position of The Heritage Foundation.

The focus of my testimony will be how to improve the secondary markets for the securities of entrepreneurial firms generally and, specifically, Chairman Garrett's discussion draft of the "Main Street Growth Act" which would create venture exchanges.

### *Summary*

- Improving the secondary markets for small capitalization firms will help investors achieve a higher return and reduce risk, improve entrepreneurs' access to capital and promote innovation, economic growth and prosperity.
- The three key steps to improving secondary markets for small firms are:
  1. improving the regulatory environment for existing non-exchange over-the-counter (OTC) securities traded on alternative trading systems (ATSS), primarily by (a) providing the same reduced blue sky burden that large companies currently enjoy, (b) re-establishing the list of marginable OTC securities and (c) removing impediments to market making caused by Regulation SHO;
  2. amending the Securities Exchange Act to establish venture exchanges; and
  3. improving the regulatory environment for secondary sales of private securities, primarily by codifying the so-called section 4(a)(1-1/2) exemption and ensuring that platform traded securities are eligible for the exemption.
- The discussion draft of the "Main Street Growth Act" is a very positive framework for establishing venture exchanges although some improvements are necessary for it to fully achieve its objectives. The improvements recommended include (1) amending the definition of venture security, (2) changing Regulation SHO as it applies to market-makers, (3) making it clear that large exchange listing requirements are inapplicable to venture exchanges, (4) permitting market maker support programs and (5) a few other relatively minor changes.

### *The Existing Secondary Market*

A primary securities offering occurs when an equity or debt interest in a company is issued or sold by the company. A secondary offering is when an investor who owns a security sells it to another investor. A secondary securities market is a market where investors trade securities among themselves. Stock exchanges are the leading example of secondary markets.

Many relatively small capitalization companies are listed on NASDAQ. However, a secondary market exists in securities not listed on stock exchanges. This non-exchange secondary market is the primary market for small capitalization company securities that either do not meet the

exchange listing standards or do not want to incur the expense of an exchange listing.<sup>1</sup> These non-exchange markets fall into two broad categories. The first category is called the over-the-counter market (OTC).<sup>2</sup> Most OTC equity or debt securities are today traded on one of OTC Markets' three tiers.<sup>3</sup> Some are traded on other alternative trading systems (ATSs)<sup>4</sup> and some are traded by other means. The Financial Industry Regulatory Authority (FINRA) recently closed its OTC Bulletin Board (OTCBB) because its trading platform generated increasingly little interest.<sup>5</sup> The second category is the private market where investors buy and sell securities, often restricted securities,<sup>6</sup> with or without broker-dealer intermediation.<sup>7</sup>

### *Why Secondary Markets Matter*

Entrepreneurial capital formation is important to a well-functioning economy. Dynamic small and start-up companies are critical to job creation, productivity improvement and new consumer product development.<sup>8</sup> Yale economist William Nordhaus has estimated that 98 percent of the

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<sup>1</sup> Expenses include relatively high listing fees and compliance with various exchange requirements regarding corporate governance and other matters.

<sup>2</sup> 17 CFR §240.15c1-1 through §240.15c6-1, "Rules Relating to Over-the-Counter Markets"; "Regulation of the OTC Equities Market." See also, OTC Markets <http://www.otcmarkets.com/content/doc/otc-market-regulation.pdf>.

<sup>3</sup> About 10,000 securities are traded using OTC Markets' ATS. See "Our Three Tiered Marketplaces," OTC Markets Group <http://www.otcmarkets.com/learn/otc-market-tiers>.

<sup>4</sup> See Regulation ATS, 17 CFR §242.300 *et seq.*; Alternative Trading System ("ATS") List <http://www.sec.gov/foia/ats/atstlist0415.pdf>. As of April 6, 2015 there were approximately 90 Alternative Trading Systems with a Form ATS on file with the SEC. ATSs serve many functions. According to a recent SEC paper, 96 percent of ATS trading volume is in credit instruments or derivatives, Laura Tuttle, "Alternative Trading Systems: Description of ATS Trading in National Market System Stocks," October 2013, p. 5 [http://www.sec.gov/marketstructure/research/ats\\_data\\_paper\\_october\\_2013.pdf](http://www.sec.gov/marketstructure/research/ats_data_paper_october_2013.pdf).

<sup>5</sup> John McCrank, "Wall St. Watchdog to Shut Penny-Stock Market, Boost OTC Oversight," Reuters, October 8, 2014 <http://www.reuters.com/article/2014/10/08/finra-regulations-otc-idUSL2N0S32A120141008>; David Feldman, "FINRA Plans OTCBB Shutdown," October 29, 2014 <http://www.davidfeldmanblog.com/finra-plans-otcbb-shutdown/>; FINRA, "OTCBB.com Shutdown," <http://www.finra.org/industry/otcbb/otcbbcom-shutdown>.

<sup>6</sup> Generally, restricted securities are securities acquired in unregistered, private offering from the issuing company or from an affiliate of the issuer, 17 CFR §230.144(a)(3).

<sup>7</sup> This private market is primarily populated by accredited investors. These sales are often made in reliance on SEC rules permitting resales by investors subject to certain restrictions – in particular, SEC Rule 144, SEC Rule 144A and the so-called section 4(a)(1 ½) exemption. For a short discussion, see Bradley Berman and Steven J Bleiberg, "Restricted Securities vs. Control Securities: What Are the Differences?," *Insights: The Corporate and Securities Law Advisor*, Vol. 27, No. 12, December 2013 [http://clsbluesky.files.wordpress.com/2013/12/insights-1213\\_berman.pdf](http://clsbluesky.files.wordpress.com/2013/12/insights-1213_berman.pdf) or Rutheford B. Campbell, Jr., "Resales of Securities Under the Securities Act of 1933," Vol. 52, No. 4, *Washington & Lee Law Review*, pp. 1333-1384 (1995) <http://scholarlycommons.law.wlu.edu/wlulr/vol52/iss4/6>.

<sup>8</sup> For a discussion of the economic importance of entrepreneurs and the decline in entrepreneurship, see David R. Burton, "Building an Opportunity Economy: The State of Small Business and Entrepreneurship," Testimony before the Committee on Small Business, United States House of Representatives, March 4, 2015 <http://www.heritage.org/research/testimony/2015/building-an-opportunity-economy-the-state-of-small-business-and-entrepreneurship>. See also Steve Strongin, Amanda Hindlian, Sandra Lawson, Katherine Maxwell, Koby Sadan and Sonya Banerjee, "The Two-Speed Economy," Goldman, Sachs & Co., April 2015, <http://www.goldmansachs.com/our-thinking/public-policy/regulatory-reform/2-speed-economy-report.pdf>; Magnus Henrekson and Dan Johansson, "Gazelles as Job Creators: A Survey and Interpretation of the Evidence," *Small Business Economics*, Vol. 35 (2010), pp. 227–244 [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=1092938](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1092938); Ryan Decker, John Haltiwanger, Ron Jarmin, and Javier Miranda, "The Role of Entrepreneurship in U.S. Job Creation and Economic Dynamism," *Journal of Economic Perspectives*, Vol. 28, No. 3 (Summer 2014), pp. 3–24 <http://pubs.aeaweb.org/doi/pdfplus/10.1257/jep.28.3.3>; Ian Hathaway and Robert Litan. "Declining Business

economic gains from innovation and entrepreneurship are received by people other than the innovator.<sup>9</sup>

A robust and liquid secondary market for the securities of entrepreneurial firms helps investors, helps companies and helps promote general prosperity. Investors usually do not want to hold their investment indefinitely. A liquid secondary market, or the likely prospect of such a market for a particular security in the near future, where securities can readily be sold quickly for a reasonable price with small transactions costs helps investors achieve a higher return on their investment and reduces risk by allowing them to liquidate the investment when they need the resources for another purpose. Lower transactions costs and greater liquidity also makes it much more likely that a security will be purchased by an investor in the first place. Removing artificial regulatory impediments to small firm secondary markets makes it more likely that investment capital will flow to entrepreneurial enterprises. Inadequate access to capital is one of the central barriers to entrepreneurial success and a better functioning secondary market for small firms will improve access to capital for entrepreneurs.<sup>10</sup>

### *Improving Existing Secondary Markets*

Creating venture exchanges is one part of a three part solution to the problem of inadequate secondary markets for small firms. However, Congress should also improve the regulatory environment for the existing secondary markets, specifically alternative trading systems where broker-dealers trade the securities of companies not listed on a national securities exchange. This includes some private securities tradable under Rule 144 and will soon include securities issued under the new Regulation A plus<sup>11</sup> and, potentially, crowdfunding securities.<sup>12</sup> Regulation A plus

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Dynamism in the United States: A Look at States and Metros,” Brookings Institution, May 2014

[http://www.brookings.edu/~media/research/files/papers/2014/05/declining%20business%20dynamism%20litan/declining\\_business\\_dynamism\\_hathaway\\_litan.pdf](http://www.brookings.edu/~media/research/files/papers/2014/05/declining%20business%20dynamism%20litan/declining_business_dynamism_hathaway_litan.pdf) .

<sup>9</sup> See William D. Nordhaus, “Schumpeterian Profits in the American Economy: Theory and Measurement,” Cowles Foundation Discussion Paper No. 1457, April 2004 <https://cowles.econ.yale.edu/P/cd/d14b/d1457.pdf>. Even if he is wrong by a factor of ten, this would still mean that 80 percent of the gains from entrepreneurship go to the public rather than the entrepreneur.

<sup>10</sup> For a good introduction to the issues, see SEC Commissioner Daniel M. Gallagher, “Whatever Happened to Promoting Small Business Capital Formation?,” September 17, 2014

<http://www.sec.gov/News/Speech/Detail/Speech/1370542976550#.VFfbI8mGkIQ> or

<http://www.heritage.org/events/2014/09/commissioner-gallagher> .See also Rutheford B. Campbell Jr., “The New Regulation of Small Business Capital Formation: The Impact - If Any - Of the JOBS Act,” April 30, 2014, *Kentucky Law Journal*, forthcoming [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=2434264](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2434264) ; David R. Burton,

“Proposals to Enhance Capital Formation for Small and Emerging Growth Companies,” Testimony before the Capital Markets and Government Sponsored Enterprises Subcommittee of the Committee on Financial Services, United States House of Representatives, April 11, 2014 <http://www.heritage.org/research/testimony/2014/04/capital-formation-for-small-and-emerging-growth-companies> ; “2013 State of Entrepreneurship Address: ‘Financing Entrepreneurial Growth’,” Kauffman Foundation Research Paper, February 5, 2013

[http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=2212743](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2212743) ; Stuart R. Cohn and Gregory C. Yadley, “Capital Offense: The SEC’s Continuing Failure to Address Small Business Financing Concerns,” *New York University Journal of Law and Business*, Vol. 4, No. 1, pp. 1-87 (2007)

<http://scholarship.law.ufl.edu/cgi/viewcontent.cgi?article=1257&context=facultypub> .

<sup>11</sup> Amendments for Small and Additional Issues Exemptions under the Securities Act (Regulation A), *Federal Register*, April 20, 2015, pp. 21806-21925 <http://www.gpo.gov/fdsys/pkg/FR-2015-04-20/pdf/2015-07305.pdf>.

<sup>12</sup> The SEC has still not promulgated final rules implementing Title III of the JOBS Act relating to crowdfunding.

and crowdfunding are both regulatory categories created by the JOBS Act.<sup>13</sup> As discussed below, Congress should also improve the regulation of the private resale of restricted securities by codifying the so-called section 4(a)(1-1/2) exemption.

### Improving the Regulation of Alternative Trading Systems (ATs)

The most important step that can be taken to improve small firm secondary markets is to reduce the burdens imposed by state blue sky laws.<sup>14</sup> Blue sky laws are state securities laws.<sup>15</sup> They increase costs considerably and introduce very long delays while waiting for state regulatory approval (if it ever comes). In some cases, it is simply impossible to ever achieve blue sky compliance for secondary offerings.<sup>16</sup> This means that companies not traded on a national securities exchange,<sup>17</sup> and therefore not having their securities treated as covered securities exempt from blue sky compliance and fees,<sup>18</sup> have serious regulatory difficulties in secondary markets. In this respect, the largest companies in the U.S. are accorded a substantially lighter regulatory burden than smaller reporting or Regulation A companies.<sup>19</sup> This is because the largest companies are traded on national securities exchanges, which are blue sky exempt under current law, while smaller companies generally cannot meet the exchange listing requirements or are unwilling or unable to bear the costs of exchange listing. Thus, smaller companies must deal with 52 regulators<sup>20</sup> while large companies need deal only with one federal regulator.

As part of the effort to strengthen the secondary markets for smaller company securities, Congress should amend section 18(b) of the Securities Act to treat all securities as covered securities that (1) are traded on established securities markets and (2) have continuing reporting obligations as (a) a registered company, (b) pursuant to Regulation A or (c) pursuant to Regulation Crowdfunding. An established securities market should be defined to include those

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<sup>13</sup> Title IV of the JOBS Act created Regulation A+ securities. Title III of the JOBS Act created crowdfunding securities.

<sup>14</sup> Rutheford B Campbell, Jr., "Federalism Gone Amuck: The Case for Reallocating Governmental Authority over the Capital Formation Activities of Businesses," 50 *Washburn Law Journal* 573 (Spring 2011) [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=1934825](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1934825) ("In retrospect, there can be little doubt that the failure of Congress to preempt state authority over the registration of securities was a significant blunder."). See also Rutheford B. Campbell Jr., "The Insidious Remnants of State Rules Respecting Capital Formation," Vol. 78 *Washington University Law Quarterly*, pp. 407-434 (2000) <http://digitalcommons.law.wustl.edu/cgi/viewcontent.cgi?article=1439&context=lawreview>.

<sup>15</sup> Roughly three-fifths of states are merit review jurisdictions where state regulators decide whether an offering is a just or fair offering, effectively substituting their investment judgment for that of investors.

<sup>16</sup> Remarks of R. Cromwell Coulson, President and CEO, OTC Markets Group, Inc. at the 33rd Annual Securities and Exchange Commission Government-Business Forum on Small Business Capital Formation, Thursday, November 2, 2014, "Record Of Proceedings," p. 63 <http://www.sec.gov/info/smallbus/sbforum112014-final-transcript.pdf> ("The other 10 percent, it's impossible. You cannot become blue sky, whether you are Roche's ADR, you are an SEC-reporting company, you're a billion-and-a-half-dollar community bank holding company. You cannot become blue sky in the United States in every jurisdiction.")

<sup>17</sup> See Securities Exchange Act section 6.

<sup>18</sup> See Securities Act section 18(b).

<sup>19</sup> While Regulation A+ Tier II *primary* offerings are blue sky exempt, secondary sales of these securities are not. This is because Tier II securities are not covered securities. For confirmation of this analysis, see specifically, Amendments for Small and Additional Issues Exemptions Under the Securities Act (Regulation A), Federal Register, April 20, 2015, p. 21862, footnote 833 <http://www.gpo.gov/fdsys/pkg/FR-2015-04-20/pdf/2015-07305.pdf>.

<sup>20</sup> 50 states, the District of Columbia and the SEC.

alternative trading system (ATS) compliant with Regulation ATS.<sup>21</sup> Given the structure of Chairman Garret's discussion draft whereby venture exchanges are treated as national securities exchanges that are exempt from various requirements, securities traded on the contemplated venture exchanges would meet the current definition of a covered security and need not be added.

This approach would have a substantial, immediate positive impact on existing markets. It is self-effectuating and does not require waiting for the SEC to promulgate venture exchange rules and then for the private sector to launch a venture exchange. It would help currently existing markets work better and reduce costs for small companies already in those markets or seeking to raise capital.

Issues involving SEC Regulation SHO (governing short-selling) and the marginability of securities are equally applicable to OTC securities traded on an ATS or the contemplated venture exchanges. They are discussed below.

### Marginability of Securities

Before NASDAQ became an exchange, the Federal Reserve maintained a list of marginable OTC stocks that an investor could borrow against.<sup>22</sup> This list should be re-established for stocks traded over-the-counter. Being able to borrow against property is an important attribute of property ownership. This is particularly important to entrepreneurs who may wish to borrow against their stock rather than being forced to sell ownership in their company to generate cash. It should also be made clear that stocks traded on venture exchanges are marginable or, if regulators decide that not all venture exchange stocks should be marginable, then the list of marginable securities should include venture exchange stocks that are eligible.

### Private Resales

Securities Act section 4(a)(1) exempts from registration "transactions by any person other than an issuer, underwriter, or dealer" from registration. Thus, the resale of restricted securities purchased by an investor in a private placement is permitted provided that certain requirements are adhered to so that the seller is not deemed an underwriter.<sup>23</sup> Rule 144,<sup>24</sup> and Rule 144A<sup>25</sup>

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<sup>21</sup> See Regulation ATS, 17 CR §242.300 *et seq.*; Alternative Trading System ("ATS") List <http://www.sec.gov/foia/docs/atlist.htm>. As of November 1, 2014 there were approximately 90 Alternative Trading Systems with a Form ATS on file with the SEC.

<sup>22</sup> See 17 CFR §220.11. For an example, see "List of Marginable OTC Stocks and List of Foreign Margin Stocks as of May 11, 1998" <http://www.federalreserve.gov/boarddocs/press/general/1998/19980424/9804otc.pdf>.

<sup>23</sup> Robert B. Robbins, "Offers, Sales and Resales of Securities Under Section 4[a](1-1/2) and Rule 144A," ALI CLE Course of Study, March 14-16, 2013

<http://www.pillsburylaw.com/siteFiles/Publications/RobbinsSalesandResalesunder4112andRule144A2013.pdf>; Rutheford B. Campbell, Jr., "Resales of Securities Under the Securities Act of 1933," Vol. 52, No. 4, *Washington & Lee Law Review*, pp. 1333-1384 (1995), <http://scholarlycommons.law.wlu.edu/wlulr/vol52/iss4/6>;

<sup>24</sup> 17 CFR §230.144 "Persons deemed not to be engaged in a distribution and therefore not underwriters;" Securities and Exchange Commission, "Rule 144: Selling Restricted and Control Securities" <http://www.sec.gov/investor/pubs/rule144.htm>.

provide regulatory safe harbors. So called section 4(a)(1-½)<sup>26</sup> is a body of case law (and practices and SEC guidance) that generally allows private resales, subject to restrictions, without the seller being deemed an underwriter and therefore the seller is able to undertake resales without registration.<sup>27</sup> More and more of these private resales are taking place on internet platforms limited to accredited investors such as Second Market or NASDAQ's Private Market.

In the interest of clarity and simplification, it would be desirable to codify this exemption so that investors and the new accredited investor internet platforms such as Second Market or NASDAQ Private Markets can operate without regulatory uncertainty.<sup>28</sup>

## *Venture Exchanges*

### Recent Interest in Venture Exchanges

There has been a significant amount of recent discussion about establishing venture exchanges. Commissioner Gallagher has proposed their creation.<sup>29</sup> Commissioner Aguilar has expressed an openness to the idea and offered some useful cautionary thoughts.<sup>30</sup> My co-panelist David Weild

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<sup>25</sup> 17 CR §230.144A "Private resales of securities to institutions;" Securities and Exchange Commission, "Section 138. Rule 144A — Private Resales of Securities to Institutions,"

<http://www.sec.gov/divisions/corpfin/guidance/securitiesactrules-interps.htm>.

<sup>26</sup> The older literature will refer to this as section 4(1-½). The JOBS Act renumbered the exemption numbers by inserting a subsection (a).

<sup>27</sup> See *Ackerberg v. Johnson, Jr.*, 892 F. 2d 1328 (8th Cir. 1989) <http://openjurist.org/892/f2d/1328/ackerberg-v-e-johnson>; Robert B. Robbins, "Offers, Sales and Resales of Securities Under Section 4[a](1-1/2) and Rule 144A," ALI CLE Course of Study, Regulation D Offerings and Private Placements, March, 2013 <http://www.pillsburylaw.com/siteFiles/Publications/RobbinsSalesandResalesunder4112andRule144A2013.pdf>. For an early discussion, see "The Section '4(1 ½)' Phenomenon: Private Resales of Restricted Securities," Vol. 34, No. 4, *The Business Lawyer* (1979), pp. 1961-1978.

<sup>28</sup> See H. R. 1839, 114<sup>th</sup> Congress, April 16, 2015, The Reforming Access for Investments in Startup Enterprises Act of 2015 or the RAISE Act of 2015, which would codify the exemption. For a brief discussion, see Nelson Griggs, NASDAQ, testimony before the Senate Banking, Housing and Urban Affairs Committee Subcommittee on Securities, Insurance and Investments, "Venture Exchanges and Small Cap Stocks," March 10, 2015 [http://www.banking.senate.gov/public/index.cfm?FuseAction=Hearings.Hearing&Hearing\\_ID=68652d9f-3c34-4620-a9ec-58740e3a4750](http://www.banking.senate.gov/public/index.cfm?FuseAction=Hearings.Hearing&Hearing_ID=68652d9f-3c34-4620-a9ec-58740e3a4750).

<sup>29</sup> SEC Commissioner Daniel M. Gallagher, "Whatever Happened to Promoting Small Business Capital Formation?, "September 17, 2014 ("I've called for the creation of "Venture Exchanges": national exchanges, with trading and listing rules tailored for smaller companies, including those engaging in issuances under Regulation A. Shares traded on these exchanges would be exempt from state blue sky registration. The exchanges themselves would be exempted from the Commission's national market structure and unlisted trading privileges rules, so as to concentrate liquidity in these venues. This should in turn bring market makers and analysts to these exchanges and their issuers, thereby recreating some of the ecosystem supportive of small companies that has been lost over the years.") <http://www.sec.gov/News/Speech/Detail/Speech/1370542976550#.VInvAHt4zYg>; SEC Commissioner Daniel M. Gallagher, "Remarks at FIA Futures and Options Expo," November 6, 2013 ("Through well-designed venture exchanges governed by scaled, sensible regulation, small companies would be provided with a proper runway for them to grow while at the same time providing investors with the material disclosures they need to make informed decisions.") <http://www.sec.gov/News/Speech/Detail/Speech/1370540289361#.VIsXvXt4zYg>.

<sup>30</sup> SEC Commissioner Luis A. Aguilar, "The Need for Greater Secondary Market Liquidity for Small Businesses," March 4, 2015 <http://www.sec.gov/news/statement/need-for-greater-secondary-market-liquidity-for-small-businesses.html>.

has put forward a version of the idea.<sup>31</sup> The Senate has held hearings.<sup>32</sup> The recent adoption of Regulation A+ to implement Title IV of the JOBS Act has raised the question of where those securities might be traded. The prospect of Title III crowdfunding raises similar issues.

### The Experience Abroad

This committee and outside analysts (including myself) need to become more familiar with the experience of other countries with venture exchanges so that we can learn from that experience. The pioneering efforts in Canada and the United Kingdom undoubtedly provide lessons about what works and what does not work so well. The Canadian TSX Venture Exchange<sup>33</sup> and the United Kingdom's Alternative Investment Market<sup>34</sup> appear to be working well but have undergone some adjustment over time. These markets appear to have had a positive economic impact in the U.K. and Canada.<sup>35</sup> There are at least a dozen similar but smaller markets in various countries around the world.<sup>36</sup>

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<sup>31</sup> David Weild and Edward Kim, "The U.S. Need for Venture Exchanges," March 4, 2015 [http://media.wix.com/ugd/c4bcbd\\_a7218106b4504d98a22c04df863b969a.pdf](http://media.wix.com/ugd/c4bcbd_a7218106b4504d98a22c04df863b969a.pdf).

<sup>32</sup> Hearing on "Venture Exchanges and Small-Cap Companies," Committee on Banking, Housing, and Urban Affairs, Subcommittee on Securities, Insurance, and Investment, March 10, 2015, [http://www.banking.senate.gov/public/index.cfm?FuseAction=Hearings.Hearing&Hearing\\_ID=68652d9f-3c34-4620-a9ec-58740e3a4750](http://www.banking.senate.gov/public/index.cfm?FuseAction=Hearings.Hearing&Hearing_ID=68652d9f-3c34-4620-a9ec-58740e3a4750).

<sup>33</sup> "TSX Venture Exchange Celebrates its 15th Anniversary," November 28, 2014 [http://www.tmx.com/en/news\\_events/news/news\\_releases/2014/11-28-2014\\_TMXGroup-TSXV-Anniversary.html](http://www.tmx.com/en/news_events/news/news_releases/2014/11-28-2014_TMXGroup-TSXV-Anniversary.html).

<sup>34</sup> London Stock Exchange, AIM <http://www.londonstockexchange.com/companies-and-advisors/aim/aim/aim.htm>.

<sup>35</sup> Grant Thornton, "Economic Impact of AIM and the Role of Fiscal Incentives," September 2010 <http://www.londonstockexchange.com/companies-and-advisors/aim/publications/documents/grantthorntonaimeconomicimpact.pdf>; Edward Peter Stringham and Ivan Chen, "The Alternative of Private Regulation: The London Stock Exchange's Alternative Investment Market as a Model," Mercatus Center Working Paper No. 12-30, Oct 18, 2012 [http://mercatus.org/sites/default/files/LondonAIM\\_StringhamChen\\_v1-0.pdf](http://mercatus.org/sites/default/files/LondonAIM_StringhamChen_v1-0.pdf); Cécile Carpentier and Jean-Marc Suret, "The Canadian Public Venture Capital Market," April 2009 <http://www.cirano.qc.ca/pdf/publication/2009s-08.pdf>.

<sup>36</sup> For example, Australia's Asia Pacific Technology Exchange (<http://www.apx.com.au/APX/Public/EN/Default.aspx>), the National Stock Exchange of Australia (<http://www.nsx.com.au/>) and Australia's SIM VSE (<http://simvse.com.au/>); Hong Kong's Growth Enterprise Market ([http://www.hkgem.com/root/e\\_default.aspx](http://www.hkgem.com/root/e_default.aspx)) [Market capitalization: \$10 billion]; Euronext's Free Market (<https://www.euronext.com/en/marches-libre>), Euronext's Alternext (<https://www.euronext.com/en/listings/nyse-alternext>) [Market capitalization of predecessor: \$8 billion]; Borsa Italiana (<http://www.borsaitaliana.it/homepage/homepage.en.htm>) [Market capitalization: \$0.6 billion]; The Brazilian Organized Over-The-Counter Market (<http://www.bmfbovespa.com.br/en-us/services/trading-platforms/otc-market.aspx?idioma=en-us>) maintained by BM&FBOVESPA (Bolsa de Valores, Mercadorias & Futuros de São Paulo) [Market capitalization: \$28 billion]; China's ChiNext (<http://www.szse.cn/main/en/ChiNext/aboutchinext/>) [Market capitalization: \$140 billion], Japan's JASDAQ (which appears to serve both NSADAQ type companies and venture companies), Korea's KOSDAQ (venture company classification) (<http://www.kosdaqca.or.kr/Eng/Greeting/>; [http://www.icsa.bz/img/research\\_pdf/Financing%20of%20SMEs%20through%20Capital%20Markets%20in%20Emerging%20Market%20Countries%282013.2%29.pdf](http://www.icsa.bz/img/research_pdf/Financing%20of%20SMEs%20through%20Capital%20Markets%20in%20Emerging%20Market%20Countries%282013.2%29.pdf)) [Market capitalization: \$102 billion (not all of which represents venture-type companies)]; India's National Stock Exchange Small and Medium Enterprises (SME) Platform ([http://www.nseindia.com/getting\\_listed/content/sml\\_med\\_enterprise.htm](http://www.nseindia.com/getting_listed/content/sml_med_enterprise.htm)) and the Enterprise Securities Market of the Irish Stock Exchange (<http://www.ise.ie/Products-Services/List-your-company/ESM/>) [Market capitalization: \$38 billion]. The Toronto TSX Market has a market capitalization of \$41 billion and the U.K.'s AIM has a market capitalization of \$100 billion. Market capitalization figures are from Laura Biasion, "UK and Italian Alternative Investment Markets: challenges and opportunities" (2012) [http://tesi.cab.unipd.it/44175/1/Biasion\\_Laura.pdf](http://tesi.cab.unipd.it/44175/1/Biasion_Laura.pdf) based on 2012 World Federation of Exchanges data.



## The American Stock Exchange's Emerging Company Marketplace (ECM) Experience

On March 18, 1992, the American Stock Exchange (Amex) launched the Emerging Company Marketplace (ECM) with an initial 22 firms. Amex closed the market on May 11, 1995. During its life, the ECM listed a total of 65 firms. The median market capitalization fell from its original \$18.4 million down to \$6.8 million.<sup>37</sup>

There are a number of lessons that may be learned from this experience. As part of the Amex, the ECM had no incentive to keep firms from graduating to a regular Amex listing. The successful firms generally graduated to a listing on the senior market, leaving behind the unsuccessful ones. Thus, there may be merit in venture exchanges being independent from larger exchanges. In addition, a number of scandals associated with early issuers damaged the reputation of the exchange. Exchanges should be vigilant in enforcing rules barring "bad actors." Lastly, the bid-ask spreads may have been so small that broker-dealers were unable to profitably make markets or otherwise support ECM companies.<sup>38</sup>

### *The Discussion Draft of the "Main Street Growth Act"*

The core provisions of the discussion draft and its structure are sound. It would have a positive impact on the secondary markets. There are, however, some changes that need to be made for the proposal to fully achieve its objectives.

The bill would allow national securities exchanges or national securities exchange applicants to elect to become venture exchanges. In the discussion draft, venture exchanges would be exempt from Regulation NMS<sup>39</sup> (except for 17 CFR 242.613 relating to a consolidated audit trail) and would also be exempt from Regulation ATS.<sup>40</sup> Regulation NMS is the core regulation governing stock exchanges. NMS stands for national market system. Regulation ATS regulates alternative trading systems. In addition, venture exchanges would not be required to submit any data to a securities information processor or to use decimal pricing.

Venture exchanges would only be able to trade 'venture securities.' Venture securities are defined in the draft as the securities of either an 'early-stage, growth company' or an "emerging growth company." The latter is a category of company created by Title I of the JOBS Act and is, in general, a company that has total annual gross revenues of less than \$1 billion. An 'early-stage, growth company,' as defined, is effectively a Regulation A issuer that has not gone public that has \$2 billion or less in assets.

Importantly, an emerging growth company is a temporary category. Under Securities Act section 2(a)(19)(B), after five years a company is no longer an emerging growth company for purposes

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<sup>37</sup> Reena Aggarwal and James Angel, "The Rise and Fall of the AMEX Emerging Company Marketplace," April 1998.

<sup>38</sup> Ibid. See also SEC Commissioner Luis A. Aguilar, "The Need for Greater Secondary Market Liquidity for Small Businesses," March 4, 2015 <http://www.sec.gov/news/statement/need-for-greater-secondary-market-liquidity-for-small-businesses.html>.

<sup>39</sup> 17 CFR §242.600 *et seq.*

<sup>40</sup> 17 CFR §242.300 *et seq.*

of the Act. This, in effect, puts a five year time limit on any registered company's time on the venture exchange. The company would then either have to meet the requirements of a NASDAQ or NYSE listing or leave the exchange, presumably for the OTC Markets ATS. This would make the venture exchange a much less attractive place to list in the first place but also quite often force profitable, successful firms that are actively traded from the exchange. This would make it much less likely that the venture exchange would be successful. This defect can be easily remedied through the simple expedient of defining a venture security as the securities of an 'early-stage, growth company' or of any registered company that had total annual gross revenues of less than \$1 billion in the previous fiscal year.<sup>41</sup>

The definition of a venture security, if this change is made, would be sufficiently broad – a billion in annual gross revenues or \$2 billion in assets – that it would appear to address, as a legal matter, the “adverse selection” concerns that successful firms will quickly graduate to NSADAQ or the NYSE while only less successful firms will remain on the venture exchanges and, therefore, that the venture exchange market come to be thought of as a market populated by either very new and risky firms or relatively unsuccessful firms. By way of comparison, firms at the bottom of the Fortune 1000 have revenues of about \$2 billion.<sup>42</sup> It is, of course, quite possible that firms will choose to list on NASDAQ for business reasons and the adverse selection problem will develop in any event.

NASDAQ's lowest tier – the “capital market” -- has three potential ways to meet NASDAQ listing standards: (1) an equity standard, (2) a market value standard and a (3) net income standard. They are all multipart standards. In general, a firm that has been operating for two years, has equity of \$5 million and a public float of \$15 million will meet the equity standard. A firm with equity of \$4 million and a public float of \$15 million and a market capitalization of \$50 million will meet the market value standard. A firm with equity of \$4 million and a public float of \$5 million and earnings of \$750,000 will meet the earnings standard. There are also requirements as to number of shareholders, number of market makers, number of publicly held shares, share price and corporate governance.<sup>43</sup> It is clear that the contemplated venture exchanges will compete with the NASDAQ capital market tier.

NYSE listing standards are complex, but in general, the NYSE requires firms to have earnings of \$10 million annually or a market capitalization of \$200 million.<sup>44</sup>

### Securities Exchange Act National Securities Exchanges Provisions

Section 6 of the Securities Exchange Act governs national securities exchanges and would, under the draft, govern venture exchanges. In reviewing section 6, I did not find any of its provisions to be problematic for venture exchanges. The SEC retains strong authority over the nature of the

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<sup>41</sup> Rules would have to be provided for venture exchange exit of firms that no longer met the requirement because they exceeded the revenue limitation. There is nothing that says that cannot be handled by rules of the exchange itself or by SEC rule.

<sup>42</sup> MEDNAX, Inc. was ranked no. 998 in 2013 and had revenues of \$1.8 billion.

<http://fortune.com/fortune500/2013/mednax-inc-998/>

<sup>43</sup> NASDAQ Initial Listing Guide, January 2015 <https://listingcenter.nasdaq.com/assets/initialguide.pdf>.

<sup>44</sup> NYSE Listed Company Manual, Section 1, The Listing Process <http://nysemanual.nyse.com/LCM/Sections/>.

venture exchanges because they must petition the Commission for national securities exchange status.

### Covered Securities

Importantly, since venture exchanges are national securities exchanges under the draft, securities listed on a venture exchange would be covered securities under section 18(b)(1)(B) of the Securities Act. However, because section 18(b)(1)(B) of the Securities Act provides that the national securities exchange must have “listing standards that the Commission determines by rule (on its own initiative or on the basis of a petition) are substantially similar to the listing standards applicable to securities” traded on the NYSE or NASDAQ. This latter provision entails the possibility that the SEC may feel bound, or may choose to do so on policy grounds, to require standards that are inappropriate for a venture exchange. Accordingly, I would recommend that the draft be revised to make it clear that large exchange listing standards provisions of subparagraph (B) are inapplicable to venture exchanges.

### Regulation NMS

The draft exempts venture exchanges from most of Regulation NMS. This is probably appropriate. It is certainly appropriate for the many aspects of Regulation NMS that are not appropriate in a periodic auction model which may be how venture exchanges choose to trade some of the smallest capitalization companies.

It is not, of course, the case that all of the rules in Regulation NMS should be ignored by a venture exchange. It is, however, likely that the exchange’s rules combined with FINRA rules will be adequate. Allowing the exchange to decide many of these issues will provide needed flexibility and room for experimentation. Moreover, different venture exchanges may adopt different competing rules and, as a general proposition, this is likely to be constructive. Having Congress and the SEC try to dictate in advance the proper set of rules in detail is almost certainly a mistake. Moreover, given the slowness of the political process, a mistake by Congress or the SEC could take years to correct and potentially doom the venture exchange experiment. Finally, the SEC will have substantial authority over venture exchange structure and rules by virtue of the petition process.

Section (m)(2)(C) of the draft itself requires venture exchanges to “disseminate last sale and quotation information on terms that are fair and reasonable and not unreasonably discriminatory.” This is analogous to the basic requirement of Regulation NMS Rules 601 and 602. A venture exchange is going to have to fashion rules governing customer limit orders, customer account statements, the financial strength and exchange conduct of participating broker-dealers, the role of market makers, and so on.

The draft rejects the provisions of Regulation NMS Rule 612 which requires stocks be priced in increments of one penny. Section (m)(2)(B) of the draft requires pricing increments of at least \$0.05. I believe that a larger pricing increment than a penny is almost certainly appropriate in relatively thin markets like those on a venture exchange. However, in general, decisions as to size of the pricing increment should be left to the exchanges.

### Regulation ATS

To the extent that Congress seeks to be more prescriptive and impose rules on venture exchanges rather than allow the exchange to adopt its own rules, Regulation ATS is generally a better place to look than Regulation NMS. For example, as a supplement to the requirements of Section (m)(2)(C) of the draft, Congress may want to consider something analogous to the fair access rules in Regulation ATS Rule 301(b)(5) and the record-keeping requirements in Rule 302 (they are logical and benign and something similar would have to be in any exchanges rules). In addition, a comparison of Rule 303 (relating to record preservation requirements) to Regulation NMS Rule 613 may show that Rule 303 is a better model than Rule 613 for venture exchanges.

### Regulation SHO

Market makers are instrumental to the marketplace. They provide liquidity by continuously providing both bid and ask quotes (i.e. offers to buy and to sell). For broker-dealers making a market in a less actively traded securities such as OTC securities or those traded on the contemplated venture exchanges, the short sale close-out requirement under Regulation SHO should be relaxed. The relatively short close-out period under 17 CFR §242.204(a)(3) – three days after settlement – makes market makers reluctant to fill substantial buy orders without raising the security's price because of "buy-in risk." Allowing them more time to cover their short positions will lead to less volatility in these less liquid markets. A revised draft should address this issue which, I believe, most market participants regard as problematic in small capitalization stocks.

Some have suggested that broker-dealers should be required to "hard locate" shares to borrow before shorting any security.<sup>45</sup> Although this idea should be evaluated seriously, it may impede the willingness of market-makers to seamlessly fill buy orders.

### FINRA

Policy-makers should not forget that the rules of the Financial Industry Regulatory Authority (FINRA) will apply to broker-dealers in connection with their venture exchange transactions. There may be some FINRA rules that need to be modified to accommodate venture exchanges. This needs to be systematically evaluated. On the other hand, FINRA rules will regulate broker-dealers operating on the exchanges and, therefore, there is a need for fewer additional statutory or SEC rules governing the venture exchanges. For example, FINRA Rule 5310 (relating to best execution and interpositioning) imposes duties on broker-dealers to buy or sell so that the resultant price to the customer is as favorable as possible under prevailing market conditions and prohibits interpositioning third parties.

### Ownership and Governance

The question of whether it is better for venture exchanges to be member (broker-dealer) owned or investor owned is an interesting and important question. NASDAQ made the transition from

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<sup>45</sup> See, e.g., Weild & Kim, *op. cit.*, p. 18.

member ownership to investor ownership in 2000. It is likely that sponsors of venture exchanges will choose different ownership and governance models. It is not clear which approach will be more successful. I do not believe that Congress or the SEC should specify the type of ownership.

### Issue Support

It is important that the venture exchange be structured so that broker-dealers can make money by making markets in securities listed on the exchange. Part of the formula will be creating interest in the listed issues, which will require research and analyst coverage. Venture exchanges need to take this into account when adopting their rules and structuring the exchange if they are to be successful. Congress and the SEC, however, should stay out of these decisions. The venture exchanges have a strong interest in getting the balance right and competition from NASDAQ, OTC Markets and others will prevent them from adopting a model that is unfair to investors.

Congress should, however, make it clear in the venture exchange legislation that market maker support programs are permitted (both on the exchanges and in the OTC market) so issuers, if they choose, can compensate broker-dealers for making a market in their stock.

### Sarbanes-Oxley

Emerging growth companies are exempt from the Sarbanes-Oxley internal control reporting requirements for five years. These costly requirements should not be applicable to venture exchange listed companies or any reporting companies that are not listed on a national securities exchange.

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